

**FORMULATING INNOVATION POLICY IN SME CLUSTERS: WHY PERSONAL
PHILOSOPHY OF ENTREPRENEURS MATTERS?**

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Abstract

Small and medium enterprises (SMEs) play an important role in economic development as they are the major employers in developed as well as developing economies. SMEs also create social order by promoting competition and distribution of wealth. Historically SMEs clusters have evolved to take advantages of the benefits of agglomeration, as size and proximity attracts labor, related industries, suppliers and buyers, thus promoting collaboration, operational flexibility and competitive advantage.

Ease of diffusion of knowledge in clusters makes it difficult to appropriate returns from investment in innovation. Intense competition compounds the problem as it forces firms to price at marginal costs, limiting investible surpluses. How firms can mitigate the adverse consequences of agglomeration and become innovative has attracted considerable attention of scholars and policy makers in recent years.

In this paper we argue that innovation potential of an SME cluster is dependent on the personal philosophy of the dominant entrepreneurs in the cluster. We define personal philosophy of an entrepreneur as (a) the motive force that drives action and (b) entrepreneur's attitude toward the undesirable consequences of his actions on others, and the two are co-terminus. We postulate that personal philosophy has major influence on entrepreneurial strategy and thus on innovation in clusters.

In any economic transaction the governance structure provides a framework for credible commitment. Intensity of interactions and intimacy in clusters increases information sharing and innovation. We propose that personal philosophy has direct influence on the nature of interaction within the cluster; inventive entrepreneurs would prefer an environment of trust whereas entrepreneurs who are opportunists are more likely to favor close metering and are less trusting.

We finally argue that to formulate effective policies for innovation in clusters it is important for policy makers to understand the personal philosophies of the lead entrepreneurs in the cluster. In clusters, dominated by opportunistic entrepreneurs, policies that push innovation (increase entry barriers and decrease exit barriers) would be appropriate, whereas in clusters dominated by inventive entrepreneurs policy pull (decrease entry barriers, increase exit barriers) would be more appropriate.